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No. 88-579

In The
Supreme Court of the United States
October Term, 1988

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ONEIDA MOTOR FREIGHT, INC., a corporation organized under the laws of the State of New York,

Petitioner,

vs.

UNITED JERSEY BANK, A New Jersey Corporation,

Respondent.

—o—

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

—o—

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CITATION OF REPORTED AND UNREPORTED OPINIONS

The decision of the United States District Court for the District of New Jersey in this case, which Petitioner previously stated was unreported, is reported at 75 B.R. 235 (D.N.J. 1987).

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REASONS FOR ALLOWANCE OF THE WRIT

I. THE DECISION OF THE THIRD CIRCUIT IS IN CONFLICT WITH TWO RECENT DECISIONS OF THE FIFTH CIRCUIT COURT OF APPEALS.

A. Matter of Texas Extrusion Corp.

Contrary to the argument of the Respondent in its brief in opposition to the Petition for a Writ of *Certiorari,* the decision of the United States Court of Appeals for the Third Circuit in this matter does conflict with the decision of the United States Court of Appeals for the Fifth Circuit in *Matter of Texas Extrusion Corp.,* 844 F.2d 1142 (1988), *cert.* denied, 57 U.S.L.W. 3306 (1988). In the instant case, the Third Circuit held that Petitioner's disclosure statement in its Chapter 11 bankruptcy case did not contain adequate information because it failed to disclose a possible unliquidated claim, with uncertain result, against Respondent. In *Matter of Texas Extrusion Corp.,* the Fifth Circuit stated that the Chapter 11 debtor's disclosure statement *did* contain adequate information, although *it* failed to disclose a possible claim for equitable subordination, with uncertain result, against the debtor's principal creditor. 844 F.2d at 1157. The results of Peti-

tioner's unliquidated claim herein, if prosecuted successfully, and of the debtor's claim for equitable subordination in *Matter of Texas Extrusion Corp.*, if prosecuted successfully, would be the same, to wit: an increase in the amount of assets available for distribution to general creditors.

In *Matter of Texas Extrusion Corp.*, the Fifth Circuit correctly recognized that, due to the uncertainty of the result, non-disclosure of the possible claim would not affect the adequacy of the information given to creditors. This is so because the creditors' acceptance of a proposed plan of reorganization should be based on the debtor's actual financial ability to effectuate the plan, not on conjecture as to the debtor's possible acquisition of an unknown additional amount of assets at an unforeseeable future date. In rendering its decision in the instant case, the Third Circuit failed to recognize and consider the foregoing principle of bankrutpcy law under the United States Bankruptcy Code, 11 U.S.C. section 1125. There thus exists an irreconcilable conflict between the decisions of the Third and Fifth Circuits as to adequacy of disclosure statements.

Respondent contends that *Matter of Texas Extrusion Corp.* is distinguishable from the instant case because in that case the debtor never asserted its possible claim for equitable subordination, while in the instant case Petitioner did assert its claim for lender liability against Respondent. That distinction is, however, a false distinction. The adequacy of the disclosure statement necessarily depends on the facts and circumstances as they exist at the time the disclosure statement is prepared and distributed to the creditors. Whether or not undisclosed pos-

sibilities actually occur subsequent to confirmation of the reorganization plan cannot retroactively affect the adequacy of the information at the time the disclosure was made (so long as the creditors are able to benefit from the realization of such possibilities). The information given to the creditors must be adequate to enable creditors to make an informed judgment about the proposed plan of reorganization at the time the creditors' acceptance of the plan is solicited. 11 U.S.C. sec. 1125.

B. D-1 Enterprises, Inc. v. Commercial State Bank.

The decision of the United States Court of Appeals for the Third Circuit in this matter also conflicts with the very recent decision of the United States Court of Appeals for the Fifth Circuit in *D-1 Enterprises, Inc. v. Commercial State Bank,* 852 F.2d 823 (1988). In *D-1 Enterprises, Inc.,* the Fifth Circuit held that a consent order, in a "contested matter" in a bankruptcy proceeding, lifting the automatic stay and turning over most of the debtor's assets to its principal creditor would not result in claim preclusion barring a subsequent lender liability action by the debtor against the principal creditor. The Fifth Circuit's decision in *D-1 Enterprises, Inc.* thus directly conflicts with the Third Circuit's decision in the instant case. In its decision herein, the Third Circuit used the terms "equitable estoppel" and "judicial estoppel," rather than the term *"res judicata"* that was employed by the Fifth Circuit in *D-1 Enterprises, Inc.*[1] How-

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[1] *Res judicata* was the term used by the District Court in the instant matter in ruling that orders in Petitioner's bankruptcy case precluded maintenance of an action against Respondent. *See Oneida Motor Freight, Inc. v. United Jersey Bank,* 75 B.R. 235, 238-239 (D.N.J. 1987).

ever, the Third Circuit clearly based its decision on the theory that Petitioner's lender liability action against Respondent should be barred by certain orders entered in Petitioner's bankruptcy case. Like the orders in *D-1 Enterprises, Inc.*, those orders were consent orders resulting from a "contested matter" regarding lifting of the automatic stay and the extent and validity of Respondent's lien. There thus exists an irreconcilable conflict between decisions of the Third and Fifth Circuits regarding the preclusive effect of orders entered in "contested matters" under the United States Bankruptcy Code upon subsequent litigation of claims by debtors.[2]

Given the existence of these conflicting decisions of the Circuit Courts of Appeals, this Court should grant a Writ of *Certiorari* in order to review the decision of the Third Circuit in this matter, in light of its contravention of the legislative intent of the United States Bankruptcy Code.

II. THE CASES RELIED UPON BY THE THIRD CIRCUIT ARE DISTINGUISHABLE AND INAPPOSITE.

Respondent discusses, at pages 7-9 of its brief, three cases that the Third Circuit relied upon in making its decision in this matter, and that Respondent presumably

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[2] The Court will note that Respondent suggests, in its brief at page 7 footnote 2, that *Matter of Texas Extrusion Corp.* must be inapplicable to the instant case because "the Fifth Circuit did not even cite to its opinion in *Southmark Properties* in *Texas Extrusion.*" (*Southmark Properties v. Charles House Corp.*, 742 F.2d 862 (5th Cir. 1984), a case regarding *res judicata* effect of bankruptcy proceedings, was relied upon by the Third Circuit in the present case.) The Court will also note that in *D-1 Enterprises, Inc.*, the Fifth Circuit did cite to, and expressly declined to follow, as not controlling, its decision in *Southmark Properties*. 852 F.2d at 826.

contends vindicate that decision: *County Fuel Co. v. Equitable Bank Corp.*, 832 F.2d 290 (4th Cir. 1987); *In re Galerie des Monnaies of Geneva, Ltd.*, 55 B.R. 253 (Bkrtcy. S.D.N.Y. 1985), aff'd 62 B.R. 224 (S.D.N.Y. 1986); and *Monroe County Oil Co. v. Amoco Oil Co.*, 75 B.R 158 (S.D. Ind. 1987). However, each of these three cases is distinguishable from and inapposite to the instant matter, and the Third Circuit's reliance thereon was misplaced.

A. County Fuel Co. v. Equitable Bank Corp.

The Third Circuit used the *County Fuel Co.* case to support the proposition that "equitable estoppel is required to preserve the integrity of the [bankruptcy] proceedings" because "creditors have reasonably acted in reliance." (App. 10) That use was plainly erroneous because the question whether any creditors had acted in reliance on Petitioner's bankruptcy proceedings is a question of fact that could not be determined, and should not have been determined, by the Court on the record that was before it on Respondent's motion pursuant to Rule 12 of the Federal Rules of Civil Procedure. (*See* Petition for a Writ of Certiorari at 28.) *County Fuel Co.* is also distinguishable because in that case, "successful prosecution of County Fuel's claim . . . would effectively nullify [an] adjudication" in the prior bankruptcy case. 832 F.2d at 293. By contrast, Petitioner's claims against Respondent, if successful, would not nullify any adjudication in Petitioner's bankruptcy case. (*See also* dissenting opinion of Judge Stapleton at App. 19 n.4.) Finally, there is substantial doubt whether *County Fuel Co.* was correctly decided. Like the Third Circuit's decision herein, the Fourth Circuit's decision in *County Fuel Co.* is in conflict with

the decision of the Fifth Circuit in *D-1 Enterprises, Inc., supra.*

B. In re Galerie des Monnaies of Geneva, Ltd.

In re Galerie des Monnaies of Geneva, Ltd. is distinguishable from the instant case. In that case, the bankruptcy court applied the doctrine of judicial estoppel to bar an adversary proceeding by the debtor on a preferential transfer. The debtor had affirmatively stated in its disclosure statement that it "[did] not believe any preference [had] occurred." Subsequently, the debtor learned of a possible preferential transfer, but did not amend its disclosure statement. Then, on the day of confirmation of its reorganization plan, it brought an adversary proceeding to recover the preferential transfers. In the instant case, by contrast, Petitioner plainly set forth the factual bases for this lawsuit in its disclosure statement, which also provided that Petitioner was reserving any claims or causes of action it had not released. Respondent was aware that Petitioner had refused to release Respondent from all potential claims or causes of action.

A further distinction in the instant case is that Petitioner's plan of reorganization and the confirming order both provide for retention of jurisdiction by the bankruptcy court. Consequently, the creditors of Petitioner can benefit from the prosecution of this lawsuit. In the *Galerie* case, on the other hand, bankruptcy court jurisdiction was not retained. Therefore, "a post-confirmation preference avoidance [would] benefit the debtor, not its creditors." *Galerie*, 55 B.R. at 260. This was a crucial consideration in the *Galerie* court's decision. (*See also,*

as to the distinction between *Galerie* and the instant matter, dissenting opinion of Judge Stapleton at App. 23-24.)

C. Monroe County Oil Co. v. Amoco Oil Co.

The Third Circuit used the *Monroe County* case to support the proposition that a debtor must disclose any litigation likely to arise in a nonbankruptcy context. (App. at 8.) The problem is that the Third Circuit thus used *Monroe County* to support a legal conclusion, without considering the disputed fact question upon which that conclusion depends—whether Petitioner made adequate disclosure. Indeed, Petitioner believes the content of its disclosure statement, the refusal of its counsel to give Respondent a general release, and the reservation in its reorganization plan of all claims not expressly released were adequate to put a creditor as sophisticated as Respondent on notice of the possibility of future litigation. (*See* dissenting opinion of Judge Stapleton at App. 22-23 & n.7.)

Monroe County is also distinguishable from the instant case in that the debtor therein "stated in its plan of reorganization that it retained 'all causes of action it may have under the United States Bankruptcy Code,' [but] made no reference to litigation likely to arise in a nonbankruptcy context." 75 B.R. at 162. By contrast, Petitioner herein reserved for prosecution after entry of the Confirmation Order all claims that had not been expressly released or terminated. (*See* App. at 23.)

III. RESPONDENT'S SUPPOSED RELIANCE ON PETITIONER'S ALLEGED SILENCE DURING ITS BANKRUPTCY CASE IS A FICTION THAT THIS COURT SHOULD DISREGARD.

Petitioner submits that the Third Circuit's decision contravenes the purposes of the United States Bankruptcy

Code. (Petition for Writ of Certiorari at 10-24.) Respondent attempts to refute that argument by trying to convince the Court that Respondent somehow relied upon Petitioner's alleged silence during its bankruptcy case and would be prejudiced if Petitioner were now permitted to assert a lender liability claim against Respondent. (Respondent's Brief at 13-14.)

The questions of alleged reliance by and prejudice to Respondent are questions of fact that this Court cannot resolve. Nonetheless, this Court can take cognizance of the egregious procedural error of the Third Circuit in resolving those fact questions, without an appropriate record, on a motion pursuant to Rule 12 of the Federal Rules of Civil Procedure. (Petition for Writ of Certiorari at 25-30.)

In order to defuse Respondent's attempt to distort the equities of the case, however, Petitioner respectfully calls the Court's attention to the following chronology. The arrangement for Petitioner's use of Respondent's cash collateral, and Petitioner's acknowledgment of the extent and validity of Respondent's lien, were embodied in an Order of the bankruptcy court dated July 25, 1985. That Order was followed by a Consent Order of September 19, 1985, modifying the cash collateral order, and by a Stipulation and Order of September 30, 1985, regarding payment of the amounts owed by Petitioner to Respondent. Petitioner's Schedules of Assets and Liabilities and Statement of Financial Affairs, the silence of which Respondent allegedly relied upon in agreeing to the foregoing orders, were not filed until *October* 1985. Petitioner's Disclosure Statement, the silence of which Respondent also allegedly relied upon, was not filed and distributed

until Spring 1986. Clearly, therefore, Respondent cannot validly claim reliance on Petitioner's silence. Furthermore, since Respondent was paid in full (except for certain post-petition interest and counsel fees) by October 1985, Respondent also cannot validly claim it would be prejudiced by its reliance.

Moreover, if the preclusionary ruling of the Third Circuit is allowed to stand, the effect will be to cause chaos, confusion and distortion even in the most routine bankruptcy cases. A Debtor will be compelled to disclose and raise at every stage of the case any and all possible causes of action, defenses or claims even though they may be speculative, contingent or inchoate. Such speculative disclosure will frustrate a Debtor's ability to propose and confirm a Plan of Reorganization. This grievous result, clearly violative of Congress' intent, is foreseen by the editors of the Bankruptcy Law Letter, which, in commenting on the Third Circuit's holding, opined that:

> If the decision in *Oneida Motor Freight, Inc.* is correct, a debtor will be obligated to (1) outline any claims it may have in its schedules, (2) raise the claims as counterclaims at every stage in the case, and (3) disclose the claims in any disclosure statement and plan. Whether such 'saber rattling' might have a chilling effect on the ability and willingness of parties to negotiate in a case or on the debtor's ability to obtain confirmation of a plan of reorganization is not considered by the Third Circuit in its decision.

"Valuation, Claims, and Estoppel in Bankruptcy Cases," 8 *Bankr. L. Ltr.* (WG&L) No. 10, at 2 (October 1988) (annexed hereto as Supplementary Appendix) (quoted segments at Supp. App. 5).

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CONCLUSION

This case presents important questions of federal bankruptcy law. Furthermore, the decision of the Third Circuit Court of Appeals conflicts with *two* decisions of the Fifth Circuit Court of Appeals regarding those important questions of federal bankruptcy law. By virtue of the foregoing, and for the reasons set forth in the Petition for Writ of Certiorari, it is respectfully submitted that the Petition should be granted.

Respectfully submitted,

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Dated: Oradell, New Jersey
November 11, 1988

PETITIONER'S SUPPLEMENTARY APPENDIX

BANKRUPTCY LAW LETTER

Vol. 8, No. 10 October 1988

Valuation, Claims, and Estoppel in Bankruptcy Cases

In adopting the Code, Congress recognized that the courts would be asked to value property at different times and for different purposes during the course of a bankruptcy case. To accomplish this, Section 506(a) was structured to provide that in valuing an allowed secured claim, the court should keep in mind the purpose of the valuation as well as any proposed use or disposition of property subject to the claim. After the Code was adopted, the bankruptcy courts recognized that there would be a need to limit litigation that related to the value of a claim. As a result, where a creditor sought relief from the automatic stay, several cases, including *Lexington Racquetball Club, Inc.* (58 Bankr. 103 (Bankr. E.D. Pa. 1986)) and *Transleisure Corp.* (41 Bankr. 201 (Bankr. E.D. N.Y. 1984)), have held that hearings on request for relief from the stay are not hearings at which full adjudication of counterclaims a debtor may have against the creditor should occur.

First and Second Mortgages. Two recent cases now question the holdings in these earlier decisions. The first case, *Georgia Granite Co.,* (86 Bankr. 733 (Bankr. N.D. Ga. 1988)), involved two motions for relief from the stay. One motion was brought by a creditor holding a first mortgage seeking relief under Section 362(d)(2). That section permits relief when the debtor does not have an equity in the property and the property is not necessary to an effec-

tive reorganization. The hearing on the creditor's motion, while scheduled within the 30-day period required by Section 362(e), was continued from time to time until a determination in favor of the creditor was finally made eight months later.

Stipulation as to Lack of Equity. In the interim, a creditor holding a second montgage on the property had obtained relief from the stay by a stipulation in which the debtor agreed that once the claims of creditors holding security interests in the property were valued, there was no equity in the property. Before the motion of the creditor holding the first mortgage was decided, the debtor concluded that its stipulation with the second creditor as to the lack of equity might have been in error due to an overstatement of the extent of the lien held by the first creditor.

The first creditor suggested that the debtor was estopped from asserting that there was equity in the real estate. Its theory was that the issue had been litigated and resolved by the consent order, which lifted the stay as to the creditor holding the second mortgage. The debtor, on the other hand, contended that it should not be estopped in light of new evidence discovered with respect to the first secured debt.

Debtor Estopped. Bankruptcy Judge W. Homer Drake, Jr. found for the creditor and granted relief from the stay. The court concluded that the debtor possessed sufficient incentive to defend against the motion for relief from the stay brought by the holder of the second mortgage and yet failed to do so. Having stipulated that there was no equity

in that action, the debtor was estopped from asserting that it had equity in response to the motion of the first creditor.

Newly Discovered Evidence. The court also rejected the claim of the debtor that since its position was based on newly discovered evidence, application of the collateral estoppel doctrine was inappropriate. The court noted that newly discovered evidence will only preclude application of the doctrine if the party against whom estoppel is asserted was deprived of the crucial evidence in the prior litigation without fault of its own. Since the debtor knew of the documents (upon which its claim that the first creditor's lien was overstated) when it stipulated for relief in the second action, the documents could not be categorized as newly discovered evidence.

Prepetition Credit Agreement. A second estoppel case is *Oneida Motor Freight, Inc.* (848 F.2d 414 (3d Cir. 1988)). The schedules filed by the debtor in the case did not disclose any claims asserted by the debtor against its principal secured creditor. When the creditor sought relief from the stay, a stipulation was entered into that fixed the extent of the creditor's security interest. The amount due the creditor was subsequently paid in full. Nothing in the debtor's disclosure statement or plan of reorganization suggested that it was contemplating litigation against the creditor.

Nevertheless, after the plan of reorganization was confirmed, the debtor commenced an action in state court alleging that the creditor had breached a prepetition credit agreement entered into between the debtor and the creditor. The debtor alleged that the creditor had failed to act in accordance with the previous course of dealing between the

parties and that the creditor had breached its duty of good faith. The debtor included claims for relief based on fraudulent misrepresentation and damage to its business reputation.

Principles of Preclusion Violated. The creditor removed the action to the U.S. District Court and then moved to dismiss. The district court granted the motion, determining that the debtor's claims against the creditor arose from the same transactions that were the subject of the extensive prior brankruptcy proceedings. The creditor's failure to bring the claims to the bankruptcy court's attention thus violated fundamental principles of preclusion and barred the debtor from proceeding with the postconfirmation action.

"Deafening" Silence. Affirming, the Third Circuit categorized the silence of the debtor during the bankruptcy case with respect to its alleged claims against the creditor as "deafening." The court concluded that the debtor had failed to meet its "express obligation of candid disclosure," which it determined to be present in bankruptcy cases.

WG&L Comment: The court in *Oneida Motor Freight, Inc.* emphasized the failure of the debtor to raise any claims or counterclaims in its schedules, in its disclosure statement and in connection with the creditor's motion to lift the automatic stay. The court suggested that although full litigation of counterclaims might not be appropriate in connection with lift stay matters, nothing precluded the debtor from raising counterclaims at that time.

Having failed to disclose the existence of potential claims at appropriate stages in the case, the debtor was

estopped from later commencing its action against the creditor.

If the decision in *Oneida Motor Freight, Inc.* is correct, a debtor will be obligated to (1) outline any claims it may have in its schedules, (2) raise the claims as counterclaims at every stage in the case, and (3) disclose the claims in any disclosure statement and plan. Whether such "saber rattling" might have a chilling effect on the ability and willingness of parties to negotiate in a case or on the debtor's ability to obtain confirmation of a plan of reorganization is not considered by the Third Circuit in its decision.

Equally troublesome is the decision in *Georgia Granite Co.* From the evidence in the case, there seems little doubt that there was equity in the property. The court's use of the estoppel theory to prevent the debtor from utilizing this equity—notwithstanding its failure to pursue the defense in the first motion for relief—therefore harmed not only the debtor but also its creditors.

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Editor's Note: Cases reviewed in this issue were reported through September 15, 1988. The Bankruptcy Reform Act of 1978 is referred to herein as the Code; the former Bankruptcy Act is referred to as the Act; the Uniform Commercial Code is referred to as the UCC.

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